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## Key Takeaways

- AI-related stocks have entered the euphoric stage of a financial bubble.
- Bubbles are always defined by a simple premise: asset prices rise beyond their underlying fundamentals and companies take on capital with no realistic chance of returning to shareholders. **The risk of permanent loss of capital is now high.**
- Meanwhile, the potential to build a dynamic and diversified portfolio that doesn't take undue risk has not looked this good in decades.

## Ask Forstrong: Is the AI mania peaking?

Is anything off limits in 2024? Apparently not. The recent presidential debate in America, in an already exasperated nation, featured two grown men bickering over their golf game. Meanwhile, the Canadian government, with straight faces, raised capital gains tax on a country grappling with a productivity crisis. In the investing business, starry-eyed pundits — without the excuse of old age — triumphantly predict an imminent return to the promised land of 2% price stability (good luck with that). Everything is well-aired and on the table for 2024.

Yet one subject remains off limits: questioning the rally in AI-related stocks. The topic seems untouchable. Who, in their right mind, would challenge such an unstoppable trend?

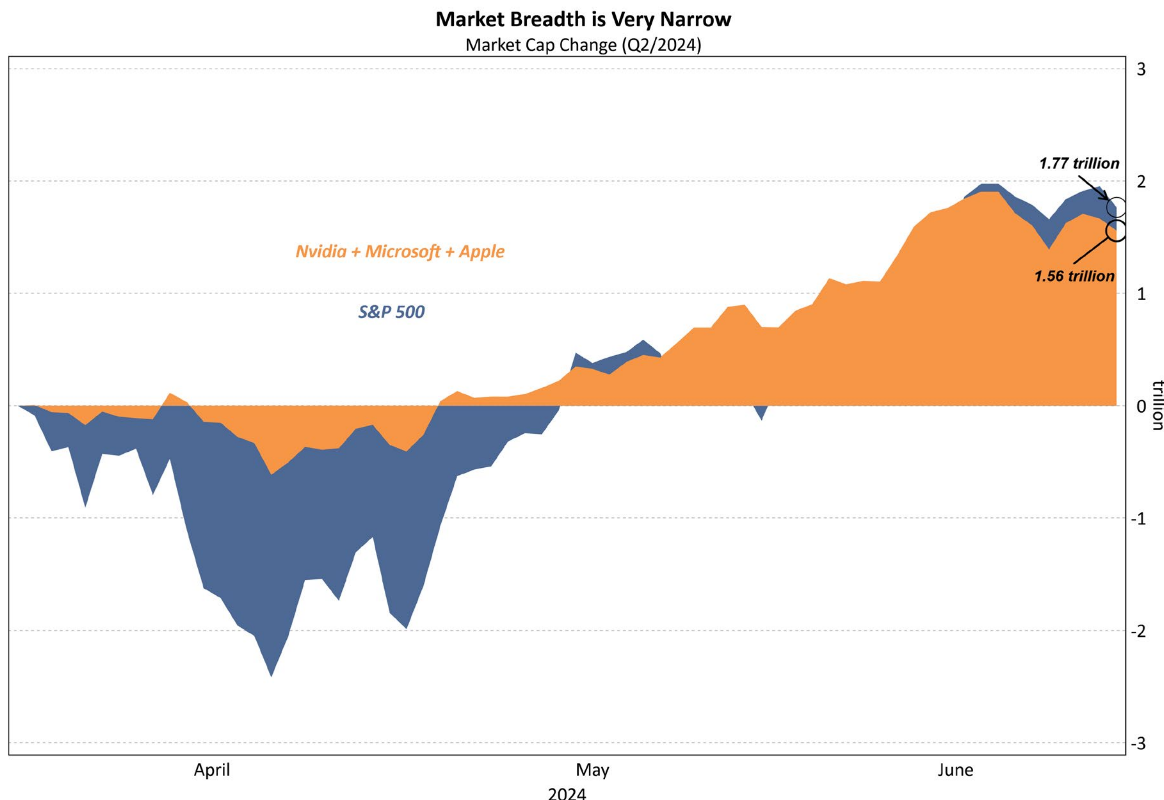
We get it. And we don't dispute it. AI will be a wildly disruptive technology that will kick over the chess board on which the current economy is being played. Anyone who has used ChatGPT has seen that generative AI can do very impressive things. Large companies are pouring colossal sums into AI. Sam Altman, the boss of OpenAI, talks openly of raising $7 trillion from Middle Eastern petrostates to create superintelligent machines. Other tech executives have not been shy to draw comparisons to the electrification wave that accelerated the industrial revolution.

These are all nice and grand statements. And, at the moment, the world seems to be taking them at face value. But let's be real: the only ones making money from AI are hardware builders like Nvidia (and a handful of others), and companies rushing to rebrand with an AI halo to boost their valuations (looking at you, Tim Cook). AI, so far, has excelled at spending money but not at producing profits.

## Euphoria In AI

AI is now following a well-worn and entirely predictable financial pattern. Bubbles always start with a solid concept that is taken to market extremes. In the first half of 2024, nearly 60% of the US stock market's gain was driven by just five companies boosted by an investor frenzy over the potential of AI — Nvidia, Microsoft, Amazon, Meta and Apple (the rally became even narrower in the second quarter, with Nvidia, Apple and Microsoft driving nearly 90% of the growth).

American politics pose another obstacle. Washington accuses Mexico of serving as a backdoor for Chinese exports circumventing US import tariffs. It is difficult to refute this. Mexico's imports from China are nearly 50% higher than pre-pandemic levels. America could easily turn on Mexico. The upcoming November election in the US could hold more significance for Mexico than its own, especially with the United States-Mexico-Canada Agreement up for review in 2026.



These surges echo patterns seen in all previous manias. Admittedly, this is tricky territory. Every asset price is really just today's number multiplied by a narrative about tomorrow. With AI, companies don't actually have to deliver on anything tangible for a while, leaving investors to fantasize, extrapolate and build stories without the nagging constraint of reality. No one knows how long it can last.

But we do know some things. Today, the market is saying that this time will be different: that the structural demand created by the AI revolution will override the cyclical nature of the industry, overcome any geopolitical headwinds and that the winners in the long term will be the same as the winners now. These are all very big assumptions.

Technology has always been cyclical, with shifts in demand happening regularly. Nvidia's valuation could come down simply because investors wake up one day to discover that supply and demand have become more balanced. The price could also come down from competition. By definition, the tech sector is a hotbed of innovation. Company leadership, especially in a period of rapid innovation, doesn't last long. There should be no debate that, in a decade's time, today's AI chip designs will be deeply obsolete. How likely is it that other tech companies, who may face a coming AI chip bottleneck (in a sector that currently earns 70% gross margins), won't find a way to create and innovate on their own (and stop sending billion-dollar checks to Nvidia)? Competition is the bedrock of capitalism.

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Internationally, fierce competitors, particularly in Asia, are readying themselves. Investors need to consider China's role. Beijing has already positioned its economy to dominate strategically important sectors like electric vehicles. After the 2018 US ban on semiconductor exports to Huawei, China made semiconductor self-sufficiency a matter of national security. Enormous resources have been poured into that endeavor. Some of that capital will disappear through corruption or incompetence. But history shows that once China has a specific industry in its crosshairs, it competes ferociously and crushes margins for others while they gain market share. AI chip design is almost certainly high on the agenda. Yet China's local stock market, trading on record low valuations, is priced as if there is zero probability of successful competition.

Where do we go from here? The abundant earnings of a few tech firms leading the AI buildout have created the illusion that tech stocks justify their heavy market weighting. However, the numbers tell a different story. Since early 2019, the tech sector's market-cap weight in the MSCI USA Index has surged from 21% to 32%, while its share of overall earnings has stagnated around 20% (figures from MRB Partners). This mirrors the late 1990s when the tech sector's market-cap weight far exceeded its earnings weight. Even if AI lives up to the hype and chip demand drives extraordinary earnings growth, this potential is already discounted by the sector's massive expansion since late 2022. In other words, the tech sector is now priced for perfection.

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### Investment Implications: Permanent Capital Losses Coming

Investors should keep it simple: the AI investing theme has all the hallmarks of a speculative mania. The precise end or trigger is unknown — it could be Big Tech cutting AI capex due to poor ROI or shareholders realizing this before corporate boardrooms do. However, we know the aftermath will result in permanent capital losses. Recovery can take years or even decades (just ask those who suffered in 1999, 2008 or 2020).

Meanwhile, the potential to build a dynamic and diversified portfolio that doesn't take undue risk has not looked this good in decades. In fact, now is an excellent time to lighten up on past AI winners and rotate into positions with more sustainable, longer-term return support. Short-dated bond yields are at their highest level in years and equity valuations outside the US are attractive at a time when our investment team forecasts improved earnings growth in non-tech sectors and select international markets. Forstrong's actively-managed and globally-balanced ETFs (Global Income and Global Growth) offer solid ways for investors to build long-term wealth without taking on concentrated risk. It's time to invest wisely and think long-term.

**Tyler Mordy, July 2024**

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